

**THE FEDERAL HOUSING FINANCE AGENCY: BAL-
ANCING STABILITY, GROWTH, AND AFFORD-
ABILITY IN THE MORTGAGE MARKET**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE OPERATIONS AND REGULATORY PRACTICES AT THE
FEDERAL HOUSING FINANCE AGENCY AND THEIR IMPACT ON THE
MORTGAGE MARKET

NOVEMBER 19, 2014

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WEDNESDAY, NOVEMBER 19, 2014

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:06 a.m., in room SD-538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

Welcome back to the Committee, Director Watt. Since this is likely my last hearing regarding the GSEs, I would like to urge my colleagues to continue our hard work to move past the housing crisis. Over the past few years, we and our staffs have spent countless hours wrestling with possible solutions and pitfalls. Some options are not practical while others are too ideological, but we still need to find a solution.

The Enterprises remain trapped in conservatorship today. FHFA continues to perform the dual role of both regulating and running the businesses of the largest entities in the mortgage market. This is not sustainable, and there is no consensus in Congress regarding how to move forward.

All the while the credit box remains extremely narrow, locking out many potential borrowers with good credit, including first-time home buyers who are needed to expand and sustain our recovery. While I oppose returning to exotic products with confusing terms, we need to find a way to bring the pendulum back to rational underwriting. Unfortunately, the tight credit conditions will remain a challenge while the future structure of the mortgage market is uncertain.

FHFA, under Director Watt's guidance, is taking steps to provide more certainty to the market and expand access for borrowers. These initiatives include expanding the loan-to-value requirements from 95 LTV to 97 LTV, updating reps-and-warrants frameworks, and developing Neighborhood Stabilization Initiative pilot programs in Detroit and Chicago.

I applaud Director Watt and his team at FHFA for taking steps to stabilize the Enterprises and the housing market. Focusing the Common Securitization Platform on the Enterprises, exploring a single security to increase liquidity, and developing stronger

counterparty oversight are all efforts that will help stabilize the market for the future. However, there is only so much that can be accomplished while the Enterprises are in limbo.

Everyone agrees that the conservatorship cannot continue forever, so I hope my colleagues will keep working toward a more certain future for the housing market. However, if Congress cannot agree on a smooth, more certain path forward, I urge you, Director Watt, to engage the Treasury Department in talks to end the conservatorship.

Before I finish, I want to thank my colleagues on this Committee, as well as their staffs and my staff, for all their hard work on housing finance reform. I especially want to thank Ranking Member Crapo and his staff for their faithful partnership.

With that, I turn to Senator Crapo for his opening statement.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. I appreciate those kind words, and I also appreciate the tenor of your remarks.

Today is an important hearing. It is the first time that Director Watt has been before this Committee for an oversight hearing since he has become the Director of the FHFA, and it is also, as you indicated, Mr. Chairman, probably the last housing hearing of the Senate Banking Committee that you will be chairing.

Mr. Chairman, I want to take this opportunity right now to tell you it has been a pleasure working with you, both in the capacities that we have had as the Chairman and the Ranking Member during this Congress, but also in the capacities that you and I have held as Subcommittee Chairmen and Ranking Members over the years. I have truly appreciated our friendship and our working relationship.

I have especially enjoyed working with you and your staff in this Congress to develop legislation to address housing finance reform, FHFA reform, improving the Terrorism Risk Insurance Program, and other important topics. We have had a productive collaboration over these years, and I wish you the best, and thank you for being a great partner.

Turning back to the task at hand and the hearing, as Director Watt's primary roles are conservator of Fannie Mae and Freddie Mac and regulator of the Federal Home Loan Bank System, that is where I want to focus today. These are two separate and distinct tasks that are incredibly complex and important.

In his role as conservator, Director Watt is obligated to conserve and preserve the assets of Fannie Mae and Freddie Mac until Congress acts to reform our housing finance market. I wish that we were sitting here today to hear Director Watt describe his plan for the implementation of the phase-in to the next housing finance system. I suspect Director Watt may wish this were the case as much as anyone else. And while we were successful in passing a bipartisan path forward out of this Committee, the ultimate goal of enacting legislation is not going to be achieved in this Congress.

This being the case, Director Watt's job in preserving the assets of these important companies becomes even more important. Since taking over as conservator, Director Watt has been active. He has

announced many actions such as a change of the Strategic Plans of Fannie and Freddie's conservatorships, which removed the reference to reducing their dominance in the market; a shift in the focus of the Common Securitization Platform to focus solely on Fannie and Freddie instead of its original purpose as a conduit for competition; and expanding Fannie and Freddie's business by reducing required borrower home equity.

In addition to these changes, HUD Secretary Castro is now making public statements that the FHFA will soon direct Fannie and Freddie to start setting aside money for trust funds. Keep in mind that if this were to occur, it would happen despite the fact that these companies have little to no capital, and thus the American taxpayer is completely on the hook for any losses.

While I have serious concerns with some of these ideas individually, perhaps my largest concern is that collectively they appear to feed a perception that the old failed status quo is slowly beginning to take hold again. Over the course of the last 2 years, this Committee held a series of in-depth hearings that examined the failures of our broken housing market and various approaches to reforming it.

While there was spirited discussion on the best path forward, one of the areas of consensus was that the status quo had failed us and that we should not return to that in the future. We cannot allow the return of Fannie and Freddie back to toxic mortgages with little or no capital. Instead, our path forward should be one based on sustainable homeownership, facilitated by a strongly capitalized private sector.

While I understand that some individuals and entities have been pressuring Director Watt to institute changes they favor via the conservatorship, we all understand that that is not the proper role of the conservator. As Director Watt noted during his confirmation hearing in addressing this Committee, "The conservator's role is to build a solid bridge from where we now are to wherever you, Congress, decide the future housing finance system will be."

I look forward today to hearing from Director Watt on how he plans to prepare that bridge and work through the preservation of the assets of these two huge taxpayer investments.

I also look forward to him hopefully dispelling any notion that Fannie and Freddie are somehow being reestablished as the long-term secondary market solution. In doing so, he should focus on how his policies as conservator will address their dominance in the market, renounce any demands or outside pressures to divert the revenue of Fannie and Freddie to any sources other than the taxpayer, and maintain sustainable, safe underwriting at these institutions.

Thank you for joining us today, Director Watt, and thank you, Mr. Chairman, again for holding this hearing.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who wish to make a brief opening statement?

[No response.]

Chairman JOHNSON. Thank you. I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now I would like to briefly introduce our witness. The Honorable Melvin L. Watt is the first Director of the Federal Housing Finance Agency. Prior to his confirmation, Director Watt served for two decades as the U.S. Representative for North Carolina's 12th Congressional District.

Director Watt, please begin your testimony.

**STATEMENT OF MELVIN L. WATT, DIRECTOR, FEDERAL
HOUSING FINANCE AGENCY**

Mr. WATT. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for inviting me to discuss the work we are doing at the Federal Housing Finance Agency. It is a privilege to participate in Chairman Johnson's last hearing, and all of us at FHFA appreciate his hard work and accomplishments on housing issues.

I also want to share my personal best wishes as you enter the new role of full-time grandparent.

FHFA's statutory mandates require us to ensure the safety and soundness of the Federal Home Loan Banks, Fannie Mae, and Freddie Mac, and to ensure that they provide liquidity in the national housing finance market.

FHFA works to balance these obligations across all of our activities. Because Fannie Mae and Freddie Mac are in conservatorship, we are also mandated by statute to preserve and conserve their assets.

In May, FHFA issued a Strategic Plan and scorecard that outlined three strategic goals for the conservatorships of Fannie Mae and Freddie Mac. Each of these strategic goals is fully aligned with FHFA's statutory mandates and fully aligned with the commitments I made to this Committee during my confirmation hearing.

The first goal is to maintain the credit availability and foreclosure prevention activities supported by the Enterprises and to do so in a safe and sound way. We have worked with the Enterprises to update and clarify their representation and warranty framework, to encourage responsible lending to creditworthy borrowers, and to enhance their outreach to small and rural lenders. Our objective here has been to normalize the availability of credit within the Enterprises' approved credit box for borrowers who have the ability to repay a loan.

The second goal is to reduce taxpayer risk by increasing the role of private capital in the mortgage market. FHFA required the Enterprises to triple their credit risk transfers in 2014, and they have already exceeded this goal by substantial margins.

Our third goal is to build a new securitization infrastructure for use by the Enterprises and adaptable for use in the future mortgage market, whatever that might be. We have defined the governance structure of the Common Securitization Platform. The Enterprises recently announced a CEO for their joint venture, and we are making much progress toward our multiyear goal of developing a single security.

Our Strategic Plan and Scorecard also have affordable rental housing priorities for the Enterprises. The focus is not to compete where there is private sector coverage of the multifamily market, but to ensure that affordable housing is available and that the

housing needs of people in rural and underserved areas are met, including areas that rely heavily on manufactured housing.

FHFA has also focused on regulating the Federal Home Loan Banks, and our efforts include a proposed rule that would clarify their membership requirements. We propose this rule because FHFA has a responsibility to ensure that the banks fulfill their statutory mission to support housing finance in a safe and sound manner.

I want to emphasize that getting feedback from stakeholders is a crucial part of our policymaking process. We will strongly consider comments made by Members of this Committee and the public in determining our final rule on the bank membership standards as well as our other proposals, including guarantee fees, single security, and enterprise housing goals.

I thank you, and I look forward to answering your questions.

Chairman JOHNSON. Excuse me, Director Watt, but we have a quorum present, so we will move to Executive Session.

[Whereupon, at 10:21 a.m., the Committee proceeded to other business and resumed at 10:25 a.m.]

Chairman JOHNSON. Director Watt, thank you very much for your testimony.

We will now begin asking questions of our witness. Will the clerk please put 5 minutes on the clock for each Member?

Director Watt, first I would like to thank you for extending the comment period for the Federal Home Loan Bank membership rule. How many home loan bank members would not meet the ongoing mortgage participation requirements that have been proposed?

Mr. WATT. Our review indicates preliminarily that less than 100 would be in that category. There are some that are close to the categories that we proposed or the percentages that we proposed. And, of course, we are still taking comments on that proposed rule and taking those comments into account to minimize any adverse consequences. And we will continue to do that through the comment period and through our evaluation.

Overall, there are, I think, approximately 7,500 member entities in the Federal Home Loan Bank System, so less than 100 would be a very small amount that would be adversely or could be adversely impacted even if we adopted the rule in its current form.

Chairman JOHNSON. What would be the interaction with and impact on the cost to borrowers of the proposed g-fee framework and the draft mortgage insurance eligibility requirements?

Mr. WATT. Well, we are evaluating those. One of the reasons we ultimately ended up coordinating the comment period for the g-fee input and the mortgage insurance eligibility standards is because there is a very, very strong relationship between those. We are not trying to adversely affect the availability of credit by either one of those things, but we have a responsibility to make sure that not only in normal circumstances but in distressed circumstances mortgage insurers have enough capital to perform the role that they are in the system designed to play. And they were not able—some of them were not able to perform that role in the distressed situation that we went through.

We are also not trying to control overall the entire mortgage insurance industry, but these are counterparties to Fannie Mae and Freddie Mac, and all of our counterparties need to be strong to make the system work effectively. And if they cannot play the role that they are mandated to play or are called upon to play or are contractually obligated to play in a distressed situation, then the system falls back on Fannie and Freddie; and ultimately, as Fannie and Freddie are now in conservatorship, it would fall back on the taxpayer.

So, again, this is one of those areas where we are constantly walking a balance between not adversely affecting access to credit, but making sure that the players in the system are responsible and able to fulfill the responsibilities they have in the housing finance system.

Chairman JOHNSON. As I mentioned in my opening statement, the credit box continues to be extremely narrow. What steps can FHFA take administratively to improve access to credit, while protecting current and future stability in the mortgage market?

Mr. WATT. Well, we are trying to normalize expectations of the parties who participate in this market. That is really what the representation and warranty clarifications have been about, because to the extent that there is uncertainty, lenders increase the cost of credit as a result of that uncertainty. And so as we have tried to smooth out and clarify the representation and warranty system and give lenders greater certainty, we have asked them to go back and evaluate the credit overlays that they have imposed as a result of the uncertainty as we move to a more certain system.

So we have done that. We have tried to make sure that the relationships that Fannie and Freddie and the Federal Home Loan Banks with small lenders as effective and efficient and cost-effective as they are with big lenders. So we have tried to smooth out that relationship.

There are a number of steps that we have taken to try to bring certainty and clarity to the market because anytime there is uncertainty and lack of clarity, lenders tend to increase the cost of credit to take that uncertainty into account.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

Director Watt, as I noted in my opening statement, I am concerned that collectively some of the steps that you have taken are creating a perception that a path is being charted toward a long-term return to the old failed status quo. And this may not necessarily be your intention, and I acknowledge that some simply wish for this to happen. They would like to see us have a situation permanently in which we have the Federal Government in conservatorship of Fannie Mae and Freddie Mac. We have the taxpayer permanently on the hook for all of the risk in the system, with the Federal Government dominating the secondary mortgage markets. And I have a concern that we not move in that direction and that we continue to recognize the need for reforming this housing market.

With your position comes a great responsibility to make extraordinarily clear that through all of your words and actions, it is Congress who will create the next housing finance system and that the

next housing finance system is not the conservatorship of the FHFA.

For the record, could you do that and make it crystal clear to the public that you confirm that the role of conservator, as you said in your nomination hearing, is to be the bridge builder that you described in your confirmation hearing and that it is for Congress to determine the role for a housing market in the United States?

Mr. WATT. I can certainly confirm that, and not only did I say it in my nomination hearings, I have said it consistently since then. In every speech I have given, we have made it clear that conservatorship is not, cannot be, should not be a permanent state, and that it is the role of Congress to define what the future state is. So I do not think there is any uncertainty that is being created as a result of my comments.

Now, as you say, there are people who potentially have different motivations out there, but I do not think there is any ambiguity in anything I have said about that.

Senator CRAPO. Well, thank you. I appreciate that. And I think it is important for that message to be sent.

One of the actions that you have taken at the FHFA that has concerned me is your recent announced reduction in downpayment requirements from 5 percent to 3 percent for loans that are flowing through GSEs. Seemingly in recognition that this act is going to result in higher risk for both GSEs and ultimately the U.S. taxpayer, you have stated that these loans will need to carry additional risk mitigants.

I am troubled that you would reduce borrower home equity after the problems we have seen so early, yet I am even more concerned that there has been little by way of detail on what additional taxpayer protections you are going to require. Could you elaborate on that?

Mr. WATT. I can, certainly, and I appreciate the question. The details will be coming out in early December. We announced that there will be a plan because we were working on the plan, we are working on the details. And some people heard that we were just doing this in a willy nilly fashion and did not hear the second part of the sentence, which was that there would be compensating factors taken into account.

The reality is that downpayment by itself is not necessarily a reliable indicator of whether somebody will pay a loan. It is a factor, but the best illustration I can give you is that there are—probably 75, 80 percent of the people whose mortgages are underwater now are still paying their mortgage. They have no equity.

So downpayment is not the most reliable indicator of whether a borrower will repay a loan. If they have good credit, if they have housing counseling, if they have ongoing housing counseling, post-purchase housing counseling, and know how to be responsible homeowners, those can mitigate the perceived increased risk that—

Senator CRAPO. But you are going to be establishing a set of mitigating—

Mr. WATT. Absolutely. Absolutely.

Senator CRAPO. Would those include a higher guarantee fee to offset the risk of borrower equity?

Mr. WATT. I do not know—we are working on the g-fee proposal, but understand that any loan that the GSEs make that requires less than a 20-percent downpayment also requires mortgage insurance or some other compensating factor to mitigate against the increased risk. So that will be true of these loans also.

So you can be assured that we are not making credit available to people that we cannot reasonably predict with a high degree of certainty that they will be able and willing to pay the mortgage. That is not what we are in the business to do.

Senator CRAPO. Well, thank you. My time is up. I will probably submit some additional questions to you. One of them will be to just follow up to see that we get the details on this risk mitigation activity that you are going to—

Mr. WATT. And we will be happy to come over and brief you as soon as those details—but they will be out there pretty vigorously in December.

Senator CRAPO. All right. Thank you.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you, Mr. Chairman, and this being likely one of the last if not the last hearing, let me begin by thanking you and Senator Crapo for your thoughtful, principled, and bipartisan leadership. Thank you both, gentlemen, very, very much.

Director Watt, the Housing Trust Fund and the Capital Magnet Fund payments out of the GSEs have been suspended, and we have an affordable housing crisis. I do not have to tell you that.

In June of this year, I joined 32 of my colleagues writing a letter to you asking you to go ahead and begin payments back into the funds, which I think would go a long way practically to rejuvenate or at least help a bit in the issue of housing.

Can you update us on that situation, what you intend to do, what you can do?

Mr. WATT. Happy to do so, Senator. I have indicated that before the end of this year we will address that issue directly. I think not only did we get a letter from you and a number of Senators on the side of funding the Housing Trust Fund, we also got letters from a number of Senators on the opposite side, which illustrates that walking the line between safety and soundness and access to credit, that is the space in which we operate. So there is not a decision that I make or that we make at FHFA where there is not that kind of balancing going on. And there is always a constituency on one side or the other.

Now, on the Housing Trust Fund, there are specific statutory provisions that indicate when the contributions to the Housing Trust Fund can be suspended. Those statutory provisions have not changed. They are the same statutory provisions. That does not mean that circumstances that triggered the termination may not have changed, and that is what we are evaluating at this point. And we are doing it responsibly. We are going through the process, and when we do announce a decision, we will announce it with the details of why we announced it on one side or the other. But you can expect an announcement of some kind or another on one side or the other of that issue before the end of the year.

Senator REED. Well, I am confident of your skill and agility of balancing all of these things and reaching the right side of the

chasm, so good luck, but I think a decision sooner rather than later.

I would also point out that within Senator Corker and Senator Warner's bill, there was a further indication of support for the Housing Trust Fund, so I think the concept is something that we agree. And then if you can find a way to fund it, it would practically be helpful to thousands and thousands of people.

Let me turn to another issue, and that is, the Neighborhood Stabilization Initiative, which you have been very forcefully leading. In my State we have a significant number of foreclosures. We also have a significant unemployment situation still after years and years of recession. And as you look at these pilot programs for the NSI, would you be willing to factor in unemployment to give States—not just Rhode Island but other States—that are suffering not just from housing problems but from employment problems?

Mr. WATT. We will certainly look at it, Senator, but unemployment is kind of beyond the control of the space in which we operate. And the way we arrive at the target areas in which we would do the pilot programs is we actually went to the map and identified the places that were basically the hardest hit in terms of home valuation declines, the places that had the most houses still underwater. And we have tried to craft a program, the Neighborhood Stabilization Initiative, to address those hardest-hit areas and do it carefully, test some things in those areas, and then try to replicate the things that work in those areas.

So we started, obviously, in Detroit, probably the hardest-hit place in the world. Now, unemployment was a component of that, obviously, but it was really—what was driving our decision about putting them at the top was the number of loans and houses that were underwater there, and that is something we can map. We put it up on our Web site. Every community now knows the number of distressed houses, the number of loans that are substantially behind in payment.

So those are the factors that are more related to housing that we have taken into account to this point. They tangentially relate to unemployment, and we recognize that your State is among the highest unemployment situations, so we will try to figure out—everybody now wants us to bring the Neighborhood Stabilization Initiative to their city, their county, their State, because it is a very popular thing. It has more flexibility in the way we deal with borrowers, and so I can understand why people want it. But we still have to do it responsibly and with the balance that I have talked about.

Senator REED. My time has expired, but I would unfortunately note that our housing statistics are just as unfortunate as our unemployment statistics. Our serious delinquency rate is eighth in the country. So my sense is that when Rhode Island applies, you could find—

Mr. WATT. We will certainly look carefully at it.

Senator REED. Thank you.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I, too, want to again thank both of you for your leadership. And I look forward to

what the future holds for you, and I am pretty certain I know what the future holds for Crapo, but thank you. And to our staffs——

[Laughter.]

Senator CORKER. To the staffs, I just want to thank all of you. I know the election creates uncertainties, and I know some of you will stay with us, and some of you will move on. But I really appreciate the way the two staffs worked so hard together to master housing finance and produce a product that had a lot of bipartisan support. So thank you.

To Jack Reed, my former staffer Michael Bright, who needs to get a life, just emailed me to make sure that Jack knew our support for the Housing Trust Fund was part of a compromise.

[Laughter.]

Senator CORKER. That is what you do around here. So, in any event——

Senator WARNER. \$3 to \$5 billion.

Senator CORKER. There you go. That is right.

So, in any event, Director Watt, thank you for being here, and I appreciate the genuine time we have had in our offices to talk about FHFA and the two entities that you oversee, along with other responsibilities. And I know we talked a lot about the Common Securitization Platform, and I know you are moving toward creating that.

One of the concerns that we expressed in our meeting in the office was to ensure that as this platform was being created, it was something that was useful for any entity, that it was not designed as part of some proprietary arrangement where only Freddie and Fannie benefited from it. And I think you have maybe brought in a CEO to head that up, and I just wondered if you could give us assurances as to making sure that this Common Securitization Platform is one that will be ubiquitous, meaning it can be used by all enterprises that might enter this market over time.

Mr. WATT. That is certainly our intention, Senator Corker. At the same time, to have designed a Common Securitization Platform for the future state without knowing what that future state was going to be would have been an extremely risky and costly venture. And so our feeling is that if we can design a system that works for the current, it will also work for the future. And we know what the current circumstances are.

At the same time, every one of the modules that we are working on has a future component to it also. But understand that the taxpayers have at risk now about \$5 trillion between Fannie and Freddie that, when the Securitization Platform is there, will have to be dealt with in some way. And our objective is to roll those things into a single security so that they will be marketable, right? So——

Senator CORKER. Yes. I do not want to run out of time, and I thank you for saying that. I just want you to reassure us, though, that what is not happening is a Common Securitization Platform that is going to be used as a proprietary product by——

Mr. WATT. I can assure you——

Senator CORKER.——Freddie and Fannie and not something that if we ended up moving ahead would not be useful.

Mr. WATT. I can assure you of that.

Senator CORKER. And just moving on to the single TBA market, which, again, I think is a very constructive step, as I understand it, you are working with SIFMA to create a single product, which, again, would work very much well—it would work very well with a product, if you will, that came out of this Committee from the standpoint of, again, allowing all types of guarantors, if you will, to be able to use this TBA market. Is that correct?

Mr. WATT. We absolutely are working closely with SIFMA. They are the most important player in the TBA market, and for us to try to do this without close consultation with them I think would be irresponsible.

Senator CORKER. So as you look into the future, you are dealing with the responsibilities that you have been given. You are always really clear, I think, much of it coming from your background, that you are going to carry out your operations in keeping with the laws that Congress produces.

What is the biggest risk that you see into the future if Congress does not take action on housing finance and deal with the current status that we now have? What is the biggest risk to us as a Nation, as taxpayers, as people who oversee the integrity of Government?

Mr. WATT. I think over time uncertainty about the future will more and more have greater and greater costs to us, and I think really bringing certainty to the future of housing finance in this country is critically important because, as I have indicated in answers to some of the earlier questions, uncertainty in this area causes costs to go up, and those costs result in costs to borrowers. And that has an impact on the economy because it slows down borrowers' willingness to participate, and that is true whether it is a home buyer or a renter seeking affordable rental housing.

Senator CORKER. Well, listen, thank you for your testimony, and, Mr. Chairman, thank you for the extra time.

Chairman JOHNSON. Thank you.

Senator MENENDEZ.

Senator MENENDEZ. Thank you, Chairman. Thank you, Director Watt, and I appreciate your service. And I am not surprised at the type of commitment you have and the way in which you have executed your responsibilities from our time in the House together, so I am proud of what you are doing.

I sent a letter with Senators from other affected States commending you for your decision to reconsider the guarantee fee surcharge your predecessor had attempted to put on homeowners and borrowers like in my State of New Jersey, as well as others, a surcharge that would have penalized mortgage borrowers in States where foreclosures are taking longer, even though that might be because of strong consumer protections or overloaded courts. And that proposal raised a lot of concerns. It would increase costs for new borrowers in States already suffering from foreclosure backlogs and would disincentivize States from adopting strong consumer protections despite the strong need we have seen in recent years for protections from foreclosure abuses. And I think there is far more constructive and better targeted ways to address the issue on backlogs.

So I know that this is in the process. Can you give me an update on the status of your review?

Mr. WATT. The comment period on both g-fees and mortgage insurance has expired, and we are now in the process of evaluating both of those things. They are connected to each other in some ways that are not always obvious to the public. And we are trying to sort through those connections, and I would expect probably in—hopefully in the first quarter of next year we will bring greater clarity to that area.

Senator MENENDEZ. OK. Well, I hope that clarity does not come at the cost of consumer protections and does not come at the cost—in terms of there are better ways to deal with foreclosure backlog, and we would be happy to share our views with you in that regard than just tacking on more fees to people in which it is challenging.

Mr. WATT. I should say that from our perspective those costs would not be about consumer protections. They are costs to longer foreclosure timelines because—

Senator MENENDEZ. And what I am saying is some of those longer foreclosure timelines are because there are strong—

Mr. WATT. That is right. So we are trying to sort through what is related to the consumer and what really exposes us to greater risk not as a result of consumers.

Senator MENENDEZ. Let me move to mortgage principal deduction for homeowners who are distressed or underwater. You know, in the aftermath of the financial crisis and even through our recovery, consumer debt burdens have been one of the biggest factors holding back our economy, and high levels of mortgage and other debt have caused consumers to defer expenses and cut back on other spending, which has led businesses to reduce investments and create fewer jobs, which feeds a cycle that has slowed our recovery.

Notwithstanding that, consumers have worked hard to reduce their debt, often at a great cost, but there are still more than 5 million homes that are still underwater, with underwater mortgages, including more than 12 percent in my State of New Jersey. And despite the clear economic benefits, as exemplified by the fact that the private sector was doing this, your predecessor refused to allow mortgage principal reduction by the GSEs as a policy response. And while certainly principal reduction would have had a greater impact if it had been allowed to be done earlier, there are still benefits to be gained from allowing it.

So with the benefits of allowing principal reduction pretty clear to me, to taxpayers, homeowners, and the economy, it is hard to understand why it was not allowed, especially in cases where the modification offers a positive net present value over the alternative of a foreclosure.

So do you intend to revisit your predecessor's policy on principal mortgage reduction? And what are your views on that?

Mr. WATT. We have not taken responsible principal reduction off the table as an option. We continue to look at whether there are ways to do it responsibly. But even with the private ones, it has seldom been done across the board. As I indicated in response to an earlier question, 75, 80 percent of the people who have been underwater have continued to pay their mortgage. And so we are try-

ing to find a way that we can get to the net present value, as you indicated, to be at least not a loss but a gain. And I think we are getting closer to trying to figure out what that connection is, and I would tell you that this has perhaps been the most difficult issue that I have faced as Director of the Agency.

Senator MENENDEZ. Two final comments, if I may, Mr. Chairman.

I appreciate how you are coming at it. I also would say that, to the extent that this is going to have any value to try to keep homeowners, responsible homeowners in their homes, time is of the essence here. So I look forward to the calculus and what operational costs, if any, you are calculating in that regard.

And, finally, I just want to make a case—I think my colleague Senator Reed raised it, but, you know, the Affordable Housing Trust Fund, you know, it used to receive funding from the GSE revenues as a result of the law. It was temporarily suspended. And the reality is that while we now see GSEs once again generating positive profits to the point that they have paid more to the Treasury than they have received, we do not see the allocation going back. And this is going to be critical, especially when I think about some of the GSE reform that I am hearing about and have looked at, and how do we still meet the mandate of opportunity, you know, and a duty to serve. The Affordable Trust Fund is clearly an important part of that.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman, and thank you, Director Watt. I want to say that I share a concern that was first raised by Senator Crapo about the danger that we slide back into some variation of the status quo prior to the financial crisis. I am concerned about the current overwhelming dominance of the mortgage market by the GSEs.

I know that FHFA has addressed this as recently as earlier this year in both the Conservatorship Strategic Plan and the Conservatorship Scorecard. One of the three strategic goals that is mentioned in both is to reduce taxpayer risk through increasing the role of private capital in the mortgage market, quite rightly so in my view.

In its 2013 annual report, the FSOC said, and I quote:

Higher guarantee fees are expected to help facilitate increased participation by the private sector in the mortgage markets. The Council recommends that the FHFA continue these efforts in order to help bring more private capital back into mortgage finance.

Almost immediately upon being sworn into office, you suspended the planned g-fee increases, and so I guess my question is: Do you disagree with the FSOC's opinion that higher g-fees would help to bring private capital into the market?

Mr. WATT. I am not sure I disagree with it, but I cannot tell you that I believe that that is the most important factor about bringing private capital into the market. We are trying to bring capital into the market through risk transfers, through providing certainty, and we are looking at setting out a transparent and rational basis for setting g-fees, which is part of our ongoing process.

So all of those things have their role in this process, and we are trying to look at every single one of them in a responsible, delibera-

tive way. But to say that one—you know, raising g-fees is going to bring private capital flocking back into this space I think is probably a gross exaggeration.

Senator TOOMEY. Well, that does seem to be what the FSOC says. FSOC has recommended that for exactly that purpose, and it seems to me that while there are definitely other steps that are important, I agree necessary to bring private capital in, if the Government guaranteed piece is systematically underpriced, then no matter what else you do, you are not going to get private capital to come in in that context. So I think the g-fee piece is an important part of that.

Mr. WATT. I do not think you and I are saying different things. I agree with you that it is one factor, and I agree with FSOC that it is a factor. But to elevate that above some of the other things we are doing and to approach that in a way that is different than the way we have approached other things I think would be inconsistent. We are looking at the impact that the increase in g-fees will have on bringing in private capital. We are looking at providing certainty through the representation and warranties framework. We are looking at all kinds of options that hopefully will bring private capital into the process.

But to say that we should, without a thorough analysis, just increase g-fees, without having evaluated it, I think was inconsistent with my responsibilities. And so we are getting to it. We are going to get there. But—

Senator TOOMEY. That is my follow-up question. And I have to say I do not believe that the FSOC was suggesting that this be the only mechanism and that all other options be ignored. I think the FSOC is very well aware of some other steps that need to be taken. But in any case, it has been almost a full year now since you suspended the increases that were planned by your predecessor. So how much longer is it going to take to do this analysis? When do you expect to come to a conclusion?

Mr. WATT. As I indicated in response to an earlier question, we expect to provide a framework and the rationale for it sometime during the first quarter of this coming year.

Senator TOOMEY. First quarter of next year we will have—

Mr. WATT. 2015.

Senator TOOMEY. Yes, OK. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman. And it has been a real honor to serve on this Committee with you, and thank you for the public service for more or less three decades to the people of South Dakota and to our country.

Mr. Watt, nice to see you, and I echo the words of my colleague Senator Menendez that came to the House at the same time, and thanks for the work you are doing now at FHFA.

Let me talk to you about putbacks some. You announced the third round of changes negotiated with the mortgage industry to further restrict FHFA's ability to put back defaulted loans to the lenders that improperly certified they had complied with Fannie and Freddie guidelines. These changes are intended to give a greater certainty to mortgage lenders, at least in theory, that they will in turn facilitate loans to a broader range of creditworthy bor-

rowers. But some content that it lets irresponsible lenders off the hook, leaving both taxpayers and borrowers picking up the tab.

My question is this: Since the crisis, Fannie and Freddie have put back billions in defaulted mortgages that lenders tried to pass off as eligible for purchases by GSEs. Under these new putback policies, does FHFA still have the tools it needs to hold lenders accountable if they do not follow the rules?

Mr. WATT. Yes, we have been very careful about retaining authority to put back when there is fraud or misrepresentation. But some of these elements were so uncertain about the conditions, it was paralyzing the lender community. And that was stifling the availability of credit, and it was increasing the cost of credit because they were imposing credit overlays to take into account that uncertainty.

So what we have tried to do is move some of the review of the loans that Fannie and Freddie guarantee, move more of that up to the front end, do not wait until there is a default and then put it back. If we know that we are getting good loans and we have done our due diligence at the front end, then we have got more control over that process.

But I can assure you that when there is fraud or misrepresentation in the process, we will retain the ability to put back loans throughout the life of the loan.

Senator BROWN. I hope that means you are vigilant that this—the tendency here could be that this gives banks the benefit of the doubt that homeowners do not get, but I know your values, and I know what you are doing in that job, and I know you will be vigilant about that.

Speaking of potential fraudulent activity that you mentioned a second ago, the New York Times recently this week highlighted Fannie and Freddie's use of debt collectors to pursue families who lose their homes to foreclosure for any debt that was not covered by the value of their home as it was underwater. Homeowners just starting to get back on their feet for a year or 2 years, or even longer, can find themselves with tens of thousands of dollars of new debt depending on their State's laws for collecting these deficiency judgments. Your agency has a duty to protect taxpayers, but demanding payment from borrowers who have already documented they cannot repay seems both expensive for FHFA who must pay the collectors and obviously harmful to the borrowers who cannot escape debt on a home they do not even now own.

How do you ensure that deficiency judgment cases are only brought when borrowers can truly repay?

Mr. WATT. Well, we are in the middle of a thorough review of Fannie and Freddie's practices and policies related to deficiency judgments. There may be as a result of that analysis an indication that we were spending more on that process than we were getting out of it and that there needed to be different criteria, but we have not reached that conclusion yet. But we are evaluating it carefully, and we are doing it, as we do with every other decision, based on actual information and research and documentation that we have access to.

It is a more recent evaluation. It is not something that I started in January or May. We became aware of the problem or the con-

cern that was being raised actually before the article came out recently. And——

Senator BROWN. So what does that mean you are doing to make sure that third-party collectors are following State and Federal law in these situations?

Mr. WATT. Well, we always expect our counterparties to follow State and Federal law. I mean, that is part of the contract, and we are enforcing that contract. So we are always doing that. That is a given.

But I am talking about a deeper analysis of whether and to what extent there is value in pursuing a deficiency judgment in various kinds of cases.

We have already eliminated borrowers age 65 or older, active military borrowers, bankrupt borrowers, borrowers pursuing short sales, deeds in lieu of foreclosure, and we are looking at the value of what is left. Are we really doing more—getting more benefit or doing more harm out of pursuing deficiency judgments in the States that allow it? I mean, a lot of States do not allow it in the first place.

Senator BROWN. Thank you.

Thanks, Mr. Chairman.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Well, thank you, Mr. Chairman. Let me add my voice to other colleagues thanking you for your service and also thanking Ranking Member Crapo for your great work on housing finance reform.

I would remind my colleagues that those who have raised the Housing Trust Fund, if the bipartisan reform that we advanced had moved forward for the Housing Trust Fund, that would have generated \$3 to \$5 billion a year. That would have been extraordinarily valuable on a project and a program that we all advocate but has zero money in it at this point.

Director Watt, thank you for your service. I have got a number of questions. I would like to make one quick comment, though, on the front end. As somebody who believes we do need housing finance reform—and Senator Warren and I recently wrote you a letter on a series of points, and I am going to raise a couple of them. One of the things I just want to put—hopefully you will be able to get back to me. Fannie Mae is in the process of entering into a long-term lease on what appears to be very expensive real estate. We have tried to press for some level of cost-benefit analysis. We have not gotten it. It is kind of a little bit of they are acting as a private entity, yet they are under your control, no GAO review. I really question the entities' move. They seem to be acting as if they assume the status quo is going to be 30 years going forward, and I think that is at best an uncertain assumption and one that I am not sure the taxpayer is getting full value on. So I hope you will look into that and can get back to me.

Mr. WATT. We are regularly in consultation with them, and actually, our expectation is that it will provide much, much greater flexibility for them to——

Senator WARNER. We have gotten nothing. They say they are in NDAs——

Mr. WATT. I thought we had provided a number of things to your staff, but if not, I will certainly follow up.

Senator WARNER. Yes, I am very unsatisfied with what we have got.

Mr. WATT. OK.

Senator WARNER. And, again, I will ask you to be fairly brief because I have got at least three or four areas I would like to touch on.

We are concerned about access to credit. You know, in effect, we have become—FICO scores have become the de facto standard, particularly first-time home buyers, in these challenging times, particularly when you are looking at folks with student loans and others, becomes a real hurdle.

Have you thought at all about looking at standards other than FICO and how we might bring a little more competition into this space?

Mr. WATT. We are thinking of it on an ongoing basis, not only whether it would be advantageous to have competition in the credit score area, but whether Fannie and Freddie through their own processes could evaluate creditworthiness, and they do, using things other than credit scores. So it is a part of our regular process, and it is a daily part, it is an hourly part of our regular process, because if you cannot accurately evaluate the ability of a borrower or a prospective borrower to repay, we have real trouble.

Senator WARNER. I would love to get an update on that.

The other is—and I think a number of us have probably dealt with this, and this is kind of the first-look program. How do we make sure owner-occupied individuals that may be in challenging financial straits really are going to get a fair shake? It is tough for them to go against sometimes these outside purchasers that will come in and buy up areas and the owner-occupied individual—in terms of a bit more flexibility to keep that owner-occupied—that owner in that home on ability to dig their way out. We have enormous problems with this in Prince William County, one of our suburban communities. That was one of the hardest-hit areas with the financial crisis. I hope you will take a look at that as well.

Mr. WATT. We are, on an ongoing basis, and I got the letter that you and Senator Warren sent yesterday afternoon, and we will respond to it and be available to meet with you on each one of these specific issues.

Senator WARNER. That would be great. Let me move to another area. This is kind of the other end of the spectrum, and that is around mortgage insurance rules. Obviously a lot of us raised concerns that when the financial crisis happened, a lot of the mortgage insurers were not there. And we do have to get the capital standards right, and I applaud you on moving forward in that area.

But one of the areas that I think bears some consideration is the PMIERS, you know, in terms of considering within the mortgage insurance industry premiums that are paid and that are in the process of being paid, at least applying those within the capital standards. That is a revenue stream that I believe ought to be counted. Do you want to make—I know my time has run out, but could you make a comment on that?

Mr. WATT. It is something that we are looking at very carefully because a number of people have said that our proposed rule does not take it into account and that it should take it into account.

It is a difficult issue because in defining capital and having the capital to survive in a stress situation, income generally is not considered capital. I mean, it would be like the GSEs having capital, but then allowing the g-fee income that they get to produce income be considered as part of the capital, right?

So there are arguments on both sides of this issue, and it is a very complicated issue, and interestingly enough, I have people internally who have different perspectives on it, which is why I think we will get to the best possible result because we—

Senator WARNER. And I appreciate that, and my time has expired. And we do need to make sure that in the event of another crisis, the mortgage insurers have some backing. But I do think this is an area, at least on my review, that merits some further scrutiny.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. And, again, thank you for your service. It has been a real privilege to serve with you and with Ranking Member Crapo.

Thank you for being here, Chairman Watt. I want to return to an issue that Senator Menendez raised, and that is, as you know, 5 million families lost their homes during the financial crisis, and millions more are still struggling. According to the latest data from Core Logic, a leading housing market research firm, another 5.3 million homeowners remain underwater on their homes, and people are continuing to lose their homes every day in foreclosure.

Now, we talk a little bit about the law here. One of your duties under the law is to preserve and conserve the assets of Fannie and Freddie. But another duty given equal importance by Congress—and I am reading from the law here—is to implement a plan that seeks to maximize assistance for homeowners and take advantage of available programs to minimize foreclosures.

Congress explicitly included reduction of loan principal as an option for your agency to pursue. Principal reduction is often a win-win that both helps Fannie and Freddie and helps a family. A 2013 CBO study, for example, found that even a modest principal reduction plan for Fannie and Freddie mortgages could help 1.2 million underwater homeowners, prevent 43,000 defaults, and save Fannie and Freddie about \$2.8 billion.

The Treasury Department has found that principal reductions could save Fannie and Freddie nearly \$4 billion and help half a million homeowners stay in their home.

It has been 6 years since Congress created FHFA, and in all that time, your agency has never, not once, permitted a family to reduce its principal mortgage through Fannie or Freddie.

I have asked about this repeatedly, and you have said you would look into allowing Fannie and Freddie to engage in principal reduction. You said it again today. You have been in office for nearly a year now, and you have not helped a single family, not even one, by agreeing to a principal reduction. So I want to know why this has not been a priority for you. The data are there.

Mr. WATT. It is probably an overstatement, Senator Warren, to say it has not been a priority. It has been a priority. It is just a very difficult issue, and the reason it is difficult is because we are looking for exactly what you said, which is a win-win situation. We——

Senator WARREN. Well, forgive me, though——

Mr. WATT. So we have to do this in a way that is responsible; otherwise, we just—reduced principal for everybody across the board is not what anybody, I think, is advocating for. So then we have to decide, OK, what is a responsible——

Senator WARREN. Chairman Watt, you have had a year to do that. You have known for 5 years before that what the problem was. We have two studies coming out showing that Fannie and Freddie could make money by doing this, one from the Treasury Department and one from the CBO. I am not even talking about all the private studies on this.

In the meantime during this year, you have done the reps and warranties policy, you have done the buyback policy, you have done private mortgage insurance rules. You have done a whole list of really tough technical things, and I applaud you for doing that. But people have lost their homes in the last year, and every day that you delay more families lose their homes. There are 5.4 million families out there underwater.

So I want to know: When are you going to have an answer on this one?

Mr. WATT. We are going to have the answer soon. It will not be as long as it has been, let me put it that way. You know——

Senator WARREN. How many more people have to lose their homes before we get there——

Mr. WATT. I cannot take responsibility for what decisions were made in the first 5 years. I can take responsibility——

Senator WARREN. No, but you——

Mr. WATT.—for what decisions are made in the last year. And it is not a year yet, but I think we are getting closer to—and we are doing some things that really may not call themselves principal reduction, but we are giving a lot more flexibility through the Neighborhood Stabilization Initiative.

Senator WARREN. But they are not principal reductions, so let us just be——

Mr. WATT. They are. They are principal reduction. If we facilitate the transfer of loans to other entities that do principal reduction and allow them to do principal reduction, that is principal reduction. It is not across-the-board principal reduction.

Senator WARREN. Indeed, how many families has it affected?

Mr. WATT. It has affected a number of families.

Senator WARREN. We have got 5.4 million families outstanding with underwater loans, and we have got two principal studies now showing what would happen if Fannie and Freddie were to engage in principal reduction.

I just want to add one more point before I quit here because I want to follow up on Senator Brown's concerns about pursuing people for deficiency judgments when they cannot pay. And you have said this is something you are looking at, and, again, I am glad to hear that. But there has already been a study on this.

According to an FHFA Inspector General's report from October of 2012, in 2011 Fannie and Freddie pursued about 35,000 borrowers who collectively had an unpaid balance of \$2.1 billion. Do you know how much they recovered? Do you know?

Mr. WATT. I know what the Inspector General says, but I think you are not looking at the bottom line of what the Inspector General said. The Inspector General says we should be pursuing more of these rather than less of them, and——

Senator WARREN. Well, what he says is that——

Mr. WATT. And that is the dilemma we are in. We are trying to figure out which ones make sense and which ones do not make sense, and that is the evaluation that we are doing.

Senator WARREN. Well, let us just look at his numbers. His numbers are, out of that 2.1 billion, you managed to collect \$4.7 million. That is less than one-quarter of 1 percent of the amount you went after families and hammered on them for, and that is before you account for the expenses of the collection. This is not a program that is producing money for Fannie and Freddie, but it is certainly imposing a lot of pain on families that have already lost their homes, families that have already been caught in bad mortgages, caught with robo-signing. This looks like a program to me that you do not need to spend another year on. It is a program that needs to be severely cut back.

Thank you, Mr. Chairman. Sorry for going over.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and thank you for your service as Chairman of this Banking Committee. It has been a pleasure to serve on it, and I wish you well in the next chapter of your life.

Director Watt, the FICO score system that is used by Fannie and Freddie now uses the 2004 classic model, and it weighs medical debt in a way that does not accurately reflect the role of medical debt on risk because it is kind of a special category because it often takes folks a lot of time to figure out what they actually owe in our complicated medical system.

FICO has recognized this in their modeling, so they have produced FICO 8 and 9, which more fairly treat consumers in this regard.

Why do the seller/servicer guidelines still require the 2004 model that does not take into account this improvement in analyzing medical debt?

Mr. WATT. Because the costs of changing from one FICO model to another FICO model or from FICO to an alternative credit scoring model are heavy, and the systems that have to be adjusted are complicated.

So what we are trying to do now is get through an analysis of not only FICO 8 and 9, but an alternative credit scoring model and try to come up with a system that is a better system and then adjust the operational things that it would take to——

Senator MERKLEY. Let me cut you off there because I only have a little bit of time, but I encourage you to put pedal to the metal in that regard.

Mr. WATT. We have pedal to the metal. We are at it, I guarantee you.

Senator MERKLEY. I am not quite persuaded of that, but thank you for pursuing it, because a lot of people would be more fairly treated with an appropriate credit model.

I wanted to turn to force-placed insurance. There have been reports from NPR and from AP recently, but these issues go back a long way. It is something I have been pointing out for a long time, kickbacks that go to mortgage servicers to place insurance at many times the market rate, actually often drive people into foreclosure. And, of course, that has an impact on your agency.

I understand that in June you all did issue a requirement that these kickbacks end, whether they are direct financial or in discounted services, and I applaud you for that.

Can you comment a little bit about these recent articles that seem to indicate this still is a big and challenging issue and how you are taking it on?

Mr. WATT. Well, force-placed insurance in and of itself is a big and challenging issue, and we have taken some of the abuses out of it by issuing guidelines. But I do not think I could represent to you that we have taken every concern that we have about how it is done out of the process, and we are continuing to work on methods of trying to improve the way we handle force-placed insurance.

By definition, if somebody is in default or if somebody has already moved out of the house, they have put insurers into a different situation. And there is really no good, effective market out there yet that takes that into account. So we are looking at it aggressively and trying to continue to improve it, but it is a tough area.

Senator MERKLEY. So both Fannie and Freddie at various points have looked at directly contracting for replacement insurance so that it would be at the market rate, which is fundamentally fair to the homeowner, that would eliminate the middlemen and the kickbacks. And are you willing to aggressively pursue a model which would be fundamentally fair to homeowners?

Mr. WATT. Well, I am willing to pursue a model that is fundamentally fair to homeowners, but I am not sure that you would want Fannie and Freddie to be in the insurance business themselves.

Senator MERKLEY. No. They would be contracting. That is what—

Mr. WATT. And when you say fair market value then, the risks associated with vacant properties are higher than the risks associated with occupied properties.

Senator MERKLEY. These are not vacant properties. These are often—

Mr. WATT. But you have got to make those differentials, is the point.

Senator MERKLEY. Are we providing a list of excuses here or are we going to get—

Mr. WATT. No, I am not—I am just explaining the reality of the difficulty of the problem that we are facing, Senator. I am not providing excuses. These are difficult issues, and we try to deal with them and give them the kind of consideration that—

Senator MERKLEY. OK. Well, I would like you to keep dealing with it. I am not satisfied yet that homeowners have gotten a fair

shake when we have been through this time and time again for a long period of time, and homeowners are still being saddled with insurance that is two to three times on average by various studies, in some cases four to ten times market rate. That is predatory practices. You are in a position to help stop it, and I am asking you to do so.

Mr. WATT. I think you and I have exactly the same objective.

Senator MERKLEY. Thank you.

Mr. WATT. And we are moving in the direction that you would like us to.

Senator MERKLEY. Thank you very much.

Mr. WATT. Probably not at the pace you want us to do it.

Chairman JOHNSON. Senator Heller.

Senator HELLER. Thank you, Mr. Chairman, and if I may, thank you for your leadership on this Committee, your time spent. I do appreciate it, as I know most Members of this Committee do.

I want to thank also the Ranking Member. In fact, Director Watt, I would like to continue with some of the questioning that he had beginning earlier, but thank you very much for being here, for taking time, and being here available to answer some of our questions.

As you are probably well aware, there are quite a few Members here on this Committee that are pretty passionate about housing finance reform. I am included in that group. I think most have recognized that the current models of Fannie Mae and Freddie Mac cannot remain, and we must reduce the risk that currently the American taxpayers face.

Just recently, I heard from HUD Secretary Castro when he was calling for housing finance reform, but I have not heard anything on this subject from you. In fact, when we had the Committee vote on the Johnson-Crapo housing bill, we did not hear any word from you. So I guess my question for you today is: Given your position, and, of course, the importance of this issue, are you going to continue your hands-off approach when it comes to housing finance reform? Or will you start engaging with Congress and work with us to end this current Fannie and Freddie model?

Mr. WATT. I am going to continue to say that it is—that our role at FHFA is in the here and the now—and that is what the statute gives us. It is Congress' role to tell us what the future of GSE reform is, and we have cooperated fully in terms of being a resource to the committees on all proposals, both the House and the Senate. But if the Committee is expecting me to have a position on what the future of housing GSE reform should be, they will be sorely disappointed.

Senator HELLER. OK.

Mr. WATT. I will not be—and, you know, when I left Congress, I know this is counterintuitive, but I left that role behind. And if I get embroiled in what is good and what is bad in the future of GSE reform, it is going to make it more difficult to do the job in the present of housing—

Senator HELLER. So what you are saying is do not ask for your opinion?

Mr. WATT. Beg your pardon?

Senator HELLER. Do not ask for your opinion on GSE reform? Is that what you are saying?

Mr. WATT. Well, I mean, I expressed my opinion before I became the Director, but I do not have an independent opinion now because anytime I express an opinion now, people take it as the FHFA opinion. And so——

Senator HELLER. Let me ask you for your opinion.

[Laughter.]

Senator HELLER. Do you support eliminating Fannie and Freddie under its current—as they are today?

Mr. WATT. I do not have an opinion on whether there is a Fannie and Freddie. I think there are roles that somebody will have to play in the process. And——

Senator HELLER. So there is no, yes or——

Mr. WATT. And you have got \$5 trillion of outstanding obligations now that somebody has to deal with, and that is in the current of housing finance. That is not in the future. So somebody has got to deal with that, and whether it is Fannie or Freddie or somebody else, I mean, that is, I think, a decision that Congress has to make, not FHFA.

Senator HELLER. All right. Let me switch topics here for just a minute. That has to do with the Mortgage Debt Relief Act. Director Watt, I do not think any State has felt the impact of falling home values more than the State of Nevada. Congress passed the Mortgage Debt Relief Act to ensure those who owed more on their mortgages than they do on their homes are now worth would not be hit with additional income taxes. I am not going to ask your opinion on the IRS or——

Mr. WATT. Thank you.

Senator HELLER.—being taxed on income taxes, but I think it is unfortunate. No one gets hit more than low-income and middle-income families, and I just think it is unfair, and I think most would concur that it is unfair that individuals have to pay taxes on income that they have never received.

So I guess, quickly, do you have any picture in your mind of what the consequences would be if we did not extend the Mortgage Debt Relief Act retroactively for this year or extend it into next year?

Mr. WATT. It would certainly have severe consequences for a number of decisions, but, again, that is a decision that Congress has to make. I cannot make it. And what I have realized is that sometimes expressing my opinion on things that I cannot influence have more negative impacts than they have positive impacts. So——

Senator HELLER. Well, we look to you from time to time, Director Watt. We do look to you for——

Mr. WATT. Well, I appreciate everybody looking to me, but it is just——

[Laughter.]

Mr. WATT. You know, I am in a difficult position, and I do not want to have a negative outcome as a result of something that I say. So I think I try to stay in my lane doing the things that FHFA has either perceived or real control over and trying to do those well and effectively.

Senator HELLER. Director, thank you for being here today.

Mr. WATT. Thank you.

Senator HELLER. Mr. Chairman, thank you.

Chairman JOHNSON. I would like to thank Director Watt for his testimony and for his ongoing service to our country.

This hearing is adjourned.

[Whereupon, at 11:37 a.m., the hearing was adjourned.]

[Prepared statement supplied for the record follows:]

PREPARED STATEMENT OF MELVIN L. WATT

DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

NOVEMBER 19, 2014

Chairman Johnson, Ranking Member Crapo and Members of the Committee, I am pleased to testify today about the activities of the Federal Housing Finance Agency (FHFA).

FHFA was established by the Housing and Economic Recovery Act of 2008 (HERA) and is responsible for the effective supervision, regulation, and housing mission oversight of the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System, which includes 12 Federal Home Loan Banks (FHLBanks) and the Office of Finance. The agency's mission is to ensure that these regulated entities operate in a safe and sound manner so that they serve as a reliable source of liquidity and funding for housing finance and community investment. Since 2008, FHFA has also served as conservator of Fannie Mae and Freddie Mac (together, the Enterprises).

In my statement today, I will provide a brief overview of FHFA's statutory responsibilities, an update on the Enterprises' financial condition and FHFA's supervisory and conservatorship activities related to the Enterprises, and an update on the FHLBanks' financial condition and FHFA's regulatory activities related to the FHLBanks.

FHFA's Statutory Responsibilities**I. FHFA's Regulatory Oversight of the Federal Home Loan Banks, Fannie Mae and Freddie Mac**

As part of the agency's statutory authority in overseeing the Federal Home Loan Bank System (FHLBank System) and the Enterprises, the Federal Housing Enterprises Financial Safety and Soundness Act (the Safety and Soundness Act), as amended by HERA, requires FHFA to fulfill the following duties:

“(A) to oversee the prudential operations of each regulated entity; and

“(B) to ensure that—

- (i) each regulated entity operates in a safe and sound manner, including maintenance of adequate capital and internal controls;
- (ii) the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities);
- (iii) each regulated entity complies with this chapter and the rules, regulations, guidelines, and orders issued under this chapter and the authorizing statutes;
- (iv) each regulated entity carries out its statutory mission only through activities that are authorized under and consistent with this chapter and the authorizing statutes; and
- (v) the activities of each regulated entity and the manner in which such regulated entity is operated are consistent with the public interest.”

12 U.S.C. § 4513(a)(1).

II. FHFA's Role as Conservator of Fannie Mae and Freddie Mac

As part of HERA, Congress granted the Director of FHFA the discretionary authority to appoint FHFA as conservator or receiver of Fannie Mae, Freddie Mac, or any of the Federal Home Loan Banks, upon determining that specified criteria had been met. On September 6, 2008, FHFA exercised this authority and placed Fannie Mae and Freddie Mac into conservatorships. Since they were placed into conservatorships, Fannie Mae and Freddie Mac together have received \$187.5 billion in taxpayer support under the Senior Preferred Stock Purchase Agreements (PSPAs) executed with the U.S. Department of the Treasury. FHFA continues to oversee these conservatorships.

FHFA's authority as both conservator and regulator of the Enterprises is based upon statutory mandates enacted by Congress, which include the following conservatorship authorities granted by HERA:

“(D) . . . take such action as may be—

- (iii) necessary to put the regulated entity in a sound and solvent condition; and
- (iii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity.

12 U.S.C. § 4617(b)(2)(D).

Carrying on the business of the Enterprises in conservatorships also incorporates the above-referenced responsibilities that are enumerated in 12 U.S.C. § 4513(a)(1). Additionally, under the Emergency Economic Stabilization Act of 2008 (EESA), FHFA has a statutory responsibility in its capacity as conservator to “implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer, to take advantage of . . . available programs to minimize foreclosures.” 12 U.S.C. § 5220(b)(1).

FHFA, acting as conservator and regulator, must follow the mandates assigned to it by statute and the missions assigned to the Enterprises by their charters until such time as Congress revises those mandates and missions.

FHFA’s Actions as Regulator and Conservator of Fannie Mae and Freddie Mac

As regulator and conservator of Fannie Mae and Freddie Mac, FHFA has taken actions during 2014 to ensure their safety and soundness, to ensure that they provide liquidity to the housing finance market, and to preserve and conserve the assets of both Enterprises. The following sections provide information about the financial performance and condition of both Enterprises, FHFA’s supervisory oversight of Fannie Mae and Freddie Mac, FHFA’s work toward the objectives identified in the *2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac*, and other activities concerning the Enterprises that FHFA has undertaken in 2014.

I. Financial Performance and Condition of Fannie Mae and Freddie Mac

Since the establishment of the conservatorships in 2008, the financial performance of the Enterprises has improved significantly. They have gone from having to draw funds from Treasury under the PSPAs to no longer requiring such draws. Some of the improvement in performance relates to one-time or transitory items, such as the reversal of each Enterprise’s deferred tax asset valuation allowance, legal settlements, and the release of loss reserves associated with rising house prices. But, part of the improvement is also attributable to other factors, including strengthened underwriting practices and increased guarantee fees.

While conservatorship of the Enterprises has helped stabilize their financial condition and the mortgage market, significant challenges remain. Serious delinquencies have declined but remain historically high compared to pre-crisis levels, and counterparty exposure remains a concern. While the risks from the Enterprises’ mortgage-related investment portfolios are declining as their volume shrinks, revenues from these portfolios are also shrinking. And both Enterprises continue to work on maintaining the effectiveness and efficiency of their operational and information technology infrastructures.

Following are highlights of the financial performance of the Enterprises:

Fannie Mae

- Net income for the third quarter of 2014 totaled \$3.9 billion. For the first 9 months of 2014, Fannie Mae reported earnings of \$12.9 billion compared to net income of \$77.5 billion for the first 9 months of 2013, which reflected one-time or transitory items.
- Fannie Mae has not required a Treasury draw since the fourth quarter of 2011. The cumulative amount of draws received from the Treasury to date under Fannie Mae’s PSPA is \$116.1 billion. Through September 30, 2014, Fannie Mae has paid \$130.5 billion in cash dividends to Treasury on the company’s senior preferred stock. Under the PSPA, the payment of dividends cannot be used to offset prior Treasury draws. This provision has remained unchanged since the PSPA was established.
- The credit quality of new single-family acquisitions was strong through the third quarter of 2014, with a weighted average FICO score of 743 and a weighted average loan-to-value (LTV) ratio of 77 percent.
- The serious delinquency rate was 1.96 percent for Fannie Mae’s total single-family book of business as of September 30, 2014. As of this date, the serious delinquency rate for loans acquired between 2005 and 2008 was 8.27 percent

compared to 0.34 percent for loans acquired since 2009. The serious delinquency rate for loans acquired prior to 2005 was 3.27 percent as of September 30, 2014.

- Fannie Mae continues to reduce its retained portfolio in accordance with the PSPA. As of September 30, 2014, Fannie Mae's retained portfolio balance was \$438.1 billion, which represents a decline of \$52.6 billion since the beginning of the year, when the balance was \$490.7 billion. As of September 30, 2014, Fannie Mae's retained portfolio is 27 percent agency securities, 7 percent non-agency securities, 6 percent multifamily loans, and 60 percent single-family loans.

Freddie Mac

- Net income for the third quarter of 2014 totaled \$2.1 billion. For the first 9 months of 2014, Freddie Mac reported earnings of \$7.5 billion, compared to net income of \$40.1 billion for the first 9 months of 2013, which reflected one-time or transitory items.
- Freddie Mac has not required a Treasury draw since the first quarter of 2012. The cumulative amount of draws received from the Treasury to date under Freddie Mac's PSPA is \$71.3 billion. Through September 30, 2014 Freddie Mac has paid \$88.2 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPA, the payment of dividends cannot be used to offset prior Treasury draws. This provision has remained unchanged since the PSPA was established.
- The credit quality of new single-family acquisitions remained high through the third quarter of 2014, with a weighted average FICO score of 744 and a weighted average loan-to-value (LTV) ratio of 77 percent.
- The serious delinquency rate was 1.96 percent for Freddie Mac's single-family book of business as of September 30, 2014. As of this date, the serious delinquency rate for loans originated between 2005 and 2008 was 7.66 percent compared to 0.23 percent for loans originated since 2009. The serious delinquency rate for loans originated prior to 2005 was 3.12 percent as of September 30, 2014.
- Freddie Mac continues to reduce its retained portfolio in accordance with the PSPA. As of September 30, 2014, Freddie Mac's retained portfolio balance was \$413.6 billion, which represents a decline of \$47.4 billion since the beginning of the year, when the balance was \$461.0 billion. As of September 30, 2014, Freddie Mac's retained portfolio is 43 percent agency securities, 17 percent non-agency securities, 12 percent multifamily loans, and 28 percent single-family loans.

II. FHFA's Supervisory Activities

FHFA's supervision function evaluates the safety and soundness of Enterprise operations. Safety and soundness is a priority in the achievement of FHFA objectives, execution of Enterprise strategic initiatives, and in all business and control functions. FHFA takes a risk-based approach to supervision, which prioritizes examination activities based on the risk a given practice poses to a regulated entity's safe and sound operation or its compliance with applicable laws and regulations. FHFA conducts onsite examinations at the regulated entities, ongoing risk analysis, and offsite review and surveillance. FHFA communicates supervisory standards to the regulated entities, establishes expectations for strong risk management, identifies risks, and requires remediation of identified deficiencies.

In 2014, FHFA has issued supervisory guidance to the Enterprises on topics related to mortgage servicing transfers, cyber risk management, operational risk management, and liquidity risk management. This guidance articulates FHFA's supervisory expectations related to those matters and informs examination activities.

Counterparty risks are the focus of several FHFA documents providing supervisory guidance to the Enterprises. For example, in June of this year, FHFA issued Advisory Bulletin 2014-06, *Mortgage Servicing Transfers*. This bulletin articulated FHFA's supervisory expectations for the Enterprises with regard to transfers of servicing of mortgage loans that they hold or guarantee. Pursuant to contracts with their counterparties, the Enterprises must approve the transfer of servicing operations or servicing rights. FHFA has focused on Enterprise approval processes for these transactions, due in large part to the significant recent transfers of mortgage servicing operations from federally regulated banks to nonbank entities that are generally subject to less regulation and are more concentrated in their operations. Heightened risks associated with these market developments were identified in the 2014 Annual Report of the Financial Stability Oversight Council.

The *Mortgage Servicing Transfers* bulletin outlines the standards to be applied by the Enterprises in a risk-based approach to analysis of financial, operational, and legal and compliance risk factors. Specifically, the bulletin states that the Enterprises should only approve these types of transfers when they are consistent with sound business practices, aligned with each Enterprise's board-approved risk appetite, and in compliance with regulatory and conservator requirements. Transfers should also be subject to risk-based monitoring by the Enterprises to monitor the execution of the transfers so that all servicing transfers occur in a timely manner and in accordance with approved terms, servicing guide requirements, and applicable mortgage servicing transfer-related laws and regulations.

Information security is another risk area of importance to the Enterprises and is addressed in Advisory Bulletin 2014-05, *Cyber Risk Management Guidance*, issued in May. This bulletin describes the characteristics of a cyber risk management program that the FHFA believes will enable the regulated entities to successfully perform their responsibilities and protect their environments. Assessment of system vulnerabilities, effective monitoring of cyber risks, and oversight of third parties that have access to Enterprise data are among the key expectations of FHFA.

Standards set by FHFA are also reflected in guidance to examiners provided in FHFA's Examination Manual, which was publicly released in late 2013. The manual includes 26 modules that cover various operations of the Enterprises and present background on a range of credit, market, and operational risks. The manual is a valuable tool for implementing FHFA's risk-based approach to supervision of the Enterprises and is available on FHFA's Web site.

FHFA maintains a team of examiners onsite at each Enterprise, and the examiners receive support from offsite analysts and subject matter experts. Examination teams perform targeted examinations of specific Enterprise operations and conduct ongoing monitoring of risk control functions and business lines. The examination work is performed in accordance with plans prepared at year-end for the following year for each Enterprise, taking into account factors such as analysis of existing risks, changes in business operations and strategic initiatives, and mortgage market developments. Where deficiencies are identified, examiners communicate recommendations and expectations for remedial action. Examiner risk assessments are updated during the year to ensure that emerging risks and Enterprise business changes receive appropriate examination coverage.

Findings from targeted examinations and ongoing monitoring conducted through the course of the year are relied upon by examiners in assigning ratings to each Enterprise under the ratings system adopted by FHFA in 2013. The system, known as CAMELSO, includes separate ratings for Capital, Asset quality, Management, Earnings, Liquidity, Sensitivity to market risk, and Operations. The examination findings are also incorporated into annual Reports of Examination, which capture FHFA's view of the safety and soundness of each Enterprise's operations. Information from the Reports of Examination is included in FHFA's annual Report to Congress.

III. FHFA's 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac and 2014 Initiatives

In May of this year, FHFA issued the *2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac* (2014 Conservatorship Strategic Plan), which outlines FHFA's conservatorship objectives for the Enterprises. At the same time, FHFA issued the 2014 Conservatorship Scorecard, which details activities and expectations for the Enterprises during 2014. Both the 2014 Conservatorship Strategic Plan and the 2014 Conservatorship Scorecard are centered around three strategic goals:

- **Maintain**, in a safe and sound manner, foreclosure prevention activities and credit availability for new and refinanced mortgages to foster liquid, efficient, competitive and resilient national housing finance markets.
- **Reduce** taxpayer risk through increasing the role of private capital in the mortgage market.
- **Build** a new single-family securitization infrastructure for use by the Enterprises and adaptable for use by other participants in the secondary market in the future.

FHFA has worked to further these strategic goals during 2014, and highlights of these activities are detailed below.

A. Maintain, in a safe and sound manner, foreclosure prevention activities and credit availability for new and refinanced mortgages to foster liquid, efficient, competitive and resilient national housing finance markets.

Our first strategic goal, MAINTAIN, requires Fannie Mae and Freddie Mac to carry out and strengthen, where possible, three aspects of their core business operations. First, we expect them to take actions that improve liquidity in the present single-family housing finance market. Second, we believe they should continue to improve servicing standards and foreclosure prevention actions. Third, we think they have a critical, ongoing role in the multifamily sector, particularly for affordable multifamily properties. Our objective here has been to normalize the availability of credit within the Enterprises' approved credit box for borrowers who have the ability to repay a loan, to refine servicing and loss mitigation opportunities to address borrowers still in need of assistance, and to support financing for affordable multifamily housing.

Representation and Warranty Framework

FHFA is continuing the process of updating and clarifying the Representation and Warranty Framework (Framework) for the Enterprises. This Framework provides Fannie Mae and Freddie Mac with remedies—including requiring a lender to repurchase a loan—when they discover that a loan purchase does not meet their underwriting guidelines.

Over the last several years, FHFA has worked to refine the Framework and to have the Enterprises place increased attention and resources on upfront quality control reviews. These quality control improvements enhance the Enterprises' risk management processes to identify and correct problems with the loans they purchase. This progress builds on a foundation of work to improve the Enterprises' ability to detect potential loan defects, including work to improve their data standards. More recently, both Enterprises are developing tools to provide upfront feedback to lenders on appraisals even before they purchase a loan, which addresses a problem identified in a large number of repurchase demands in recent years. In addition, any fraud or significant noncompliance that the Enterprises discover across their mortgage purchases can always trigger a repurchase.

In addition to these efforts, FHFA has also worked to bring increased clarity to the Framework to encourage lenders to reduce their credit overlays and lend throughout the Enterprises' full credit boxes. We believe that the changes to the Framework will reduce lender uncertainty about when the Enterprises will require repurchase of a loan and, as a result, pave the way for lenders to lift some of their current credit overlays and reduce the cost of credit to borrowers.

FHFA launched its efforts to update the Representation and Warranty Framework in 2012, and the first improvements went into effect for loans sold or delivered on or after January 1, 2013. These improvements relieved lenders of representation and warranties obligations related to the underwriting of the borrower, the property or the project for loans that had clean payment histories for 36 months. In May of this year, FHFA and the Enterprises announced additional refinements that addressed revisions to the payment history requirement, written notification of relief to lenders, and treatment for mortgage insurance rescissions.

More recently FHFA announced an agreement in principle on how to clarify and define the life-of-loan exclusions applicable to the Framework. The current life-of-loan exclusions are open-ended and make it difficult for a lender to predict when, or if, Fannie Mae or Freddie Mac will apply one of them. The refinements will provide all parties with additional clarification about when these exemptions apply. Additionally, these revisions maintain and support the safe and sound operations of the Enterprises and are consistent with our broader efforts to place more emphasis on upfront quality control reviews and other upfront risk management practices.

Providing Targeted Access to Credit Opportunities for Creditworthy Borrowers

Part of the Enterprises' mission is promoting access to mortgage credit for creditworthy borrowers across all market segments. We know that in today's market, there are creditworthy borrowers who have the income to afford monthly mortgage payments but do not have the money to make a large down payment and pay closing costs. As a result, Fannie Mae and Freddie Mac will shortly announce purchase guidelines that allow for 3 to 5 percent down payments, which will improve opportunities for access to credit for some of these borrowers.

To appropriately manage the Enterprises' risk, the guidelines for these loans will be targeted in their scope and will include standards that support safety and soundness. We know that the size of a down payment—by itself—is not the most reliable indicator of whether a borrower will repay a loan. As a result, the guidelines will

require that borrowers have “compensating factors” and risk mitigants—such as housing counseling, stronger credit histories, or lower debt-to-income ratios—in order to make the mortgage eligible for purchase by Fannie Mae or Freddie Mac. This approach builds on the Enterprises’ experience using compensating factors and risk mitigants. It also meets the objective to develop guidelines that look at and assess a borrower’s full financial picture and ability to repay, not just whether they have enough money for a big down payment. Additionally, like other loans with down payments below 20 percent, these loans will require credit enhancement, such as private mortgage insurance.

Working with Small Lenders, Rural Lenders and Housing Finance Agencies

During 2014, the Enterprises have continued to conduct outreach to small lenders, rural lenders and Housing Finance Agencies to strengthen their understanding of how the Enterprises might be able to better serve these institutions. These initiatives are important ones, because we know that community-based lenders and Housing Finance Agencies have a vital role in serving rural and underserved markets across the country. We also know that many community-based lenders could not be active in the housing market without access to a liquid secondary housing finance market. In recent years, the share of Enterprise acquisitions that are originated by smaller lenders has increased, and the cash window continues to be an important form of secondary market access for smaller and rural lenders. Additionally, the guarantee fees charged are by policy no longer based on volume delivered, and, as a result, ongoing guarantee fees for all lenders have converged.

Foreclosure Prevention

Since entering conservatorship, the Enterprises have continued to focus on loss mitigation and borrower assistance activities. As of August 31, 2014, the Enterprises had conducted more than 3.3 million foreclosure prevention actions since the start of the conservatorships in September 2008. However, there are still areas of the country where the housing market recovery has lagged and groups of borrowers continue to need assistance.

During 2014, FHFA has worked to improve the Enterprises’ foreclosure prevention efforts through targeted outreach. Examples of these efforts include the Neighborhood Stabilization Initiative under which the Enterprises are partnering with the National Community Stabilization Trust to develop pre-foreclosure strategies that include deeper loan modifications and timely and informed decisions about the best treatment of individual properties. FHFA has selected Detroit and Chicago for this pilot program. FHFA has also conducted targeted outreach activities to increase consumer awareness of the Home Affordable Refinance Program (HARP) as many borrowers could benefit from this program but may not fully understand that they qualify. Finally, the Enterprises developed Streamlined Modification programs to address documentation challenges associated with traditional modifications, including for deeply delinquent loans.

Moving forward, FHFA will continue to review loss mitigation options to help families stay in their homes, stabilize communities, and meet our conservatorship obligations.

Multifamily

For individuals and families who rent rather than buy, continuing to support affordable rental housing is also an ongoing priority for FHFA and the Enterprises. Under FHFA’s 2014 Conservatorship Strategic Plan and the 2014 Conservatorship Scorecard, FHFA did not require a reduction in the Enterprises’ multifamily production levels. Fannie Mae and Freddie Mac have historically played a key role in providing financing to the multifamily housing finance market throughout all market cycles and their multifamily portfolios have demonstrated excellent performance even through the recent financial crisis.

In addition, FHFA has continued to emphasize the Enterprises’ important role in the affordable rental housing market, and FHFA provided the Enterprises with additional capacity to provide financing for affordable multifamily properties beyond the multifamily volume cap established in the 2014 Conservatorship Scorecard. In establishing this policy, the focus is not for the Enterprises to compete where there is private sector coverage of the multifamily market, but to ensure that affordable housing is available and that the housing needs of people in rural and other underserved areas are met, including areas that rely heavily on manufactured housing. On multifamily purchases, we are also requiring the companies to continue sharing risk with the private sector, which Freddie Mac does through a capital markets structure and Fannie Mae does through a risk sharing model. Both approaches transfer significant risk to the private market.

B. Reduce taxpayer risk through increasing the role of private capital in the mortgage market.

FHFA's second strategic goal, REDUCE, is focused on ways to bring additional private capital into the system in order to reduce taxpayer risk. We have reformulated this goal so that it no longer involves specific steps to contract the Enterprises' market presence, which would risk having an adverse impact on liquidity. Instead, the REDUCE goal focuses on ways to scale back Fannie Mae and Freddie Mac's overall risk exposure. This approach allows us to meet our mandates of upholding safety and soundness and ensuring broad liquidity in the housing finance market.

Private Mortgage Insurer Eligibility Requirements

FHFA has continued to advance efforts to strengthen Fannie Mae and Freddie Mac's counterparty requirements for private mortgage insurers. When a borrower makes a down payment of less than 20 percent, these mortgages are required by statute to have a credit enhancement, including private capital standing behind the loan, in order to qualify for purchase by Fannie Mae or Freddie Mac. Private mortgage insurance has always played an important role in meeting this requirement and it is critical to make sure that claims can be covered in both good times and in bad times. To this end, FHFA released a Request for Input on draft Private Mortgage Insurer Eligibility Requirements. Our objective is to have the Enterprises strengthen their risk management by enhancing the financial, business and operational requirements in place for their private mortgage insurer counterparties thereby enhancing long-term claims paying ability.

FHFA is in the process of reviewing and considering the input we received as part of our comprehensive evaluation of this issue. Consistent with our statutory mandates, our assessments and policy decisions will take into account both safety and soundness considerations and possible impacts on access to credit and housing finance market liquidity.

Credit Risk Transfers and Retained Portfolio Reductions

FHFA and the Enterprises remain focused on increasing the amount of credit risk transferred from the Enterprises. FHFA increased the 2014 Scorecard target to achieve a meaningful credit risk transfer of \$90 billion in unpaid principal balance, up from \$30 billion in 2013. In addition, FHFA encouraged the Enterprises to test multiple types of credit risk transfer structures, which include securities-based transactions and insurance transactions. As of November 1, 2014, Fannie Mae has transferred the credit risk associated with \$183 billion in unpaid principal balance of single-family mortgages, and Freddie Mac has transferred credit risk associated with \$169 billion in unpaid principal balance of single-family mortgages. In each transaction, the Enterprises retained a small first-loss position in the underlying loans, sold a significant portion of the risk beyond the initial loss and then retained the catastrophic risk in the event losses exceeded the private capital support. As a result, private capital is absorbing significant credit risk on much of Fannie Mae and Freddie Mac's new purchases, thereby substantially reducing risk to taxpayers from these purchases.

In addition, both Enterprises continue to reduce the size of their retained mortgage portfolios consistent with the terms of the PSPAs, which require them to reduce their portfolios to no more than \$250 billion each by 2018. Fannie Mae and Freddie Mac have developed plans to meet this target even under adverse market conditions. As their portfolios continue to decline, they are transferring interest rate risk, securities credit risk and liquidity risk from these portfolios to the private sector.

C. Build a new single-family securitization infrastructure for use by the Enterprises and adaptable for use by other participants in the secondary market in the future.

FHFA's final strategic goal is to BUILD a new infrastructure for the Enterprises' securitization functions. This includes ongoing work to develop the Common Securitization Platform (CSP) infrastructure and to improve the liquidity of Enterprise securities. We have clarified that FHFA's top objective for the CSP is to make sure that it works for the benefit of Fannie Mae and Freddie Mac. We are also requiring that the CSP leverage the systems, software and standards used in the private sector wherever possible. This will ensure that the CSP will be adaptable for use by other secondary market actors—including private-label securities issuers—in the future. In addition, FHFA has also worked with the Enterprises to leverage the CSP in order to develop a Single Security, which we believe will improve liquidity in the housing finance markets.

Common Securitization Platform

Important progress has been made in 2014 concerning the multiyear process of developing the CSP. This includes the announcement of a Chief Executive Officer for Common Securitization Solutions (CSS)—the joint venture owned by Fannie Mae and Freddie Mac—which is the corporate entity that we expect ultimately to house and operate the CSP. Additionally, this also includes finalizing the governance structure and operating agreements between Fannie Mae and Freddie Mac concerning the CSS.

In addition, FHFA and the Enterprises have also made considerable progress on the design-and-build phase of the CSP. Each Enterprise has designated staff to work on the project at the CSS location and during 2014 this team has been developing the technology and infrastructure of the CSP platform. This includes work to incorporate the Single Security into the development of the CSP. Furthermore, Fannie Mae and Freddie Mac have reorganized their staffs with business operations and information technology experts to develop the systems and processes needed to integrate with the CSP. As this work continues, Fannie Mae and Freddie Mac staff will engage in continuous testing and will develop operating policies and procedures to ensure a smooth transition to the CSP. FHFA, Fannie Mae, and Freddie Mac are committed to achieving a seamless CSP launch, and the actions taken so far are moving us in the right direction toward this multiyear goal.

Single Security

FHFA's top priority in pursuing the Single Security is to deepen and strengthen liquidity in the housing finance markets. In today's market, the mortgage-backed securities issued by Fannie Mae and Freddie Mac trade in separate "to-be-announced" (TBA) markets. The forward-trading that takes place in TBA securities allows borrowers to lock-in a mortgage rate. The TBA market also adds efficiencies to the process, which reduces transaction costs and results in lower mortgage rates for borrowers. In today's TBA market, there is a price disparity between Fannie Mae and Freddie Mac securities largely due to greater trading volumes of Fannie Mae securities. This price disparity imposes an additional cost on Freddie Mac to remain competitive. We believe a Single Security can further strengthen market liquidity by reducing the trading disparities between Fannie Mae and Freddie Mac securities.

We have asked for public input on FHFA's proposed Single Security structure, and this Request for Input is the first step in a multiyear process. The deadline for feedback was October 13, 2014, and FHFA is working with the Enterprises to process the feedback we received and will move forward in a deliberative and transparent manner.

IV. Additional Initiatives Impacting Fannie Mae and Freddie Mac

In addition to the activities outlined above, FHFA continues to work on a number of other initiatives that impact Fannie Mae and Freddie Mac, several of which are highlighted below.

Guarantee Fees

One of the first decisions I made as Director of FHFA was to suspend increases in guarantee fees that had been announced by FHFA in December of 2013. Given the impact of these fees on the Enterprises, the housing finance markets, and on borrowers, I believed that it was critical to evaluate this issue and to get feedback from stakeholders. After additional work at FHFA, we issued a Request for Input that provides further details on how the Enterprises set these fees. The request also posed a number of questions to prompt substantive feedback about how guarantee fee levels affect various aspects of the mortgage market.

FHFA is in the process of reviewing and considering the input we have received as part of our comprehensive evaluation of this issue. Consistent with our statutory mandates, our assessments and policy decisions will take into account both safety and soundness and possible impacts on access to credit and housing finance market liquidity.

Fannie Mae and Freddie Mac Housing Goals

On August 29, 2014, FHFA issued a proposed rule to set the Enterprises' housing goals for 2015 through 2017 for both single-family and multifamily housing. While HERA changed the structure of the Enterprises' housing goals, the goals remained a component of the mission requirements of the Enterprises. This proposed rule raises questions for public comment about how best to set Fannie Mae and Freddie Mac's housing goals to encourage responsible lending that is done in a safe and sound manner, while serving the single-family and rental housing needs of lower-income families as outlined in HERA. FHFA is in the process of evaluating the comments submitted to the agency.

FHFA's Actions as Regulator of the Federal Home Loan Banks

The FHLBanks continue to play an important role in housing finance by providing a reliable funding source and other services to member institutions, including smaller institutions that would otherwise have limited access to these services. In addition, the FHLBanks have specific statutory requirements related to affordable housing, and, as a result, the FHLBanks annually contribute funds toward the development of affordable housing.

I. Financial Performance and Condition of the Federal Home Loan Banks

The financial performance and condition of the FHLBank System remains strong. Led by growth in advances, the aggregate balance sheet of the FHLBanks has increased over the past 2 years, but remains considerably smaller than in peak years. Advances totaled \$545 billion as the end of the third quarter of 2014, up from \$499 billion at year-end 2013, but down 50 percent from a peak of \$1.01 trillion in the third quarter of 2008. The overall decline in advance volume from the peak is a result of increased market liquidity from deposits and sluggish economic growth.

Following are highlights of the financial performance of the FHLBanks:

- The FHLBanks, in aggregate, reported net income of \$1.7 billion for the first three quarters of 2014 after earning \$2.5 billion in all of 2013. All twelve Banks were profitable during these quarters.
- The FHLBanks saw substantial asset growth during the first 9 months of 2014 driven by advances to members. As of the end of the third quarter of 2014, aggregate FHLBank assets totaled \$883 billion and \$545 billion in advances—up from \$835 billion and \$499 billion at the end of 2013. Advances constituted 62 percent of assets at the FHLBanks in aggregate at the end of the third quarter of 2014, up from 60 percent at the end of 2013.
- Retained earnings have grown significantly in recent years and totaled \$13.0 billion, or 1.5 percent of assets, as of the third quarter 2014.
- Also at the end of the third quarter of 2014, the Banks had an aggregate regulatory capital ratio of 5.6 percent—comfortably above the minimum of 4.0 percent.
- All FHLBanks had net asset values (equity values) in excess of the par value of their members' stock holdings. The market value of the FHLBanks is 142 percent of the par value of capital stock, the highest ratio since FHFA started tracking this metric in 2002.

II. FHFA's Supervisory and Regulatory Activities

FHFA conducts annual safety and soundness and affordable housing policy examinations of all 12 FHLBanks and the Office of Finance based on well-defined supervisory strategies. Similar to the approach described concerning supervision of the Enterprises, FHFA uses a risk-based approach to conducting supervisory examinations of the FHLBanks, which prioritizes examination activities based on the risks given practices pose to a regulated entity's safe and sound operations or its compliance with applicable laws and regulations. Additionally, FHFA's FHLBank supervision also utilizes the CAMELSO ratings system and incorporates these ratings into each FHLBanks' Report of Examination. Information from the Reports of Examination is included in FHFA's annual Report to Congress.

Over the last few years, FHFA's supervisory work has included assessments of: FHLBank mortgage purchase programs which have been expanding, the substantial increase in advances to a few very large member institutions, the FHLBanks' changing capital composition in light of their increasing retained earnings and reduced activity stock requirements, and their management of unsecured credit. We are also currently conducting reviews of FHLBank enterprise risk management structures and approaches to vendor management.

FHFA also provides the FHLBanks with supervisory guidance, in the form of Advisory Bulletins that outline the agency's regulatory expectations. In 2014, FHFA issued Advisory Bulletin 2014-02, *Operational Risk Management*, and Advisory Bulletin 2014-05, *Cyber Risk Management*, that applied to the FHLBanks. Other Advisory Bulletins applicable to the FHLBanks have covered such areas as model risk management, collateral valuation and management, and the classification of risky assets.

FHFA's supervision of the FHLBanks' expanding mortgage programs involves oversight of the significant operational issues required by two new products—Membership Partner Finance (MPF) Direct and MPF Government MBS—that the FHLBank of Chicago is likely to begin offering in late 2014 or early 2015. Under

MPF Direct, participating members would sell nonconforming and conforming, single-family, fixed-rate mortgage loans to the Chicago Bank, which would concurrently sell the loans to a third-party private investor that would accumulate the loans for securitization. The Chicago Bank expects, at least initially, that loans sold will be “jumbo conforming” loans—capped at \$729,750 for single unit loans in the contiguous United States.

Under the MPF Government MBS program, the Chicago Bank would purchase government guaranteed or insured loans, accumulate the loans on its balance sheet as held for sale, and eventually pool the loans in securities guaranteed by the Government National Mortgage Association (Ginnie Mae). The Chicago FHLBank would then sell the securities to other Federal Home Loan Banks, members approved to participate in the mortgage programs, and external investors. Initially, this product will be available only to participating members in the Chicago FHLBank’s District.

The mission focus of the FHLBank System is an important component of FHFA’s regulatory activities. FHFA has undertaken three recent efforts to oversee the housing finance mission of the FHLBanks. First, in early September, FHFA released a proposed rulemaking involving membership requirements for the FHLBanks. Congress established the FHLBank System in 1932 as a government sponsored enterprise with a focus on housing finance. Over time, Congress has expanded the membership base, expanded the types of assets that are eligible collateral for advances, and made other incremental changes to the System. However, over eighty years later, the FHLBanks are still grounded in supporting housing finance.

Under the current membership rule, institutions may gain access to the benefits of FHLBank membership by meeting a one-time test showing a minimal amount of housing finance assets at the time of application. FHFA has proposed eliminating this one-time test and, instead, requiring that FHLBank members maintain a minimal amount of housing finance assets on an ongoing basis. In addition, FHFA has proposed defining insurance company in such a way that captive insurers would no longer be eligible for FHLBank membership. Captive insurance companies only provide benefits for their parent company, which may not be eligible for FHLBank membership. While captive insurers may in some cases be involved in housing finance, their access to the FHLBank System raises a number of policy questions that we discuss in the proposed rule.

Given the importance of the issues surrounding the membership rule, FHFA extended the initial 60-day comment period for another 60 days, until January 12, 2015. As I have consistently emphasized since becoming Director of FHFA, getting input and feedback from stakeholders is a crucial part of FHFA’s policymaking process, and we will strongly consider comments made by members of this Committee as well as the public in determining our final rule.

Second, FHFA has continued a dialogue with the FHLBanks on core mission assets. This also relates to the fundamental issue of how the FHLBanks use the benefits of their status to support their housing finance mission. In partnership with the FHLBanks, I believe we are making progress in developing a framework for the fundamental characteristics of what a FHLBank’s balance sheet should look like in order to demonstrate a satisfactory mission commitment.

Finally, among our current regulatory initiatives is a review of FHFA’s Affordable Housing Policy (AHP) regulation. The AHP program provides funding for both single-family and rental affordable housing—including housing affordable to very low-income individuals and families. In 2013, the FHLBanks allocated \$297 million to their AHP programs for the purchase, construction, or rehabilitation of over 37,800 housing units. FHFA is committed to working with the FHLBanks to make this program more efficient.

Another area of ongoing regulatory work involves the merger of the FHLBanks of Des Moines and Seattle. There has been considerable change in our Nation’s financial system, in the membership base of the FHLBanks, and in market conditions across the various FHLBank districts since the FHLBank System was established in 1932. As a result, the FHLBanks have seen changes in advance demand and membership composition, which in turn has affected the fundamental franchise values of some of the FHLBanks.

As a result of these changes, the Boards of the FHLBanks of Des Moines and Seattle have determined that a combined entity would better serve the needs of their members. The Boards of both Banks voted to approve this merger on September 25, 2014. There remain additional steps in order to complete this merger, including approval by FHFA upon reviewing the Banks’ formal merger application and ratification by the members of both FHLBanks. FHFA has and will continue to work with the Banks throughout this process, and we will review and evaluate the merger application to ensure that the proposed transaction will be accomplished in a safe and

sound manner and will result in a financially strong FHLBank that supports the interests of all its members.

Conclusion

None of these activities or initiatives would be possible without the dedication of the staff at the Federal Housing Finance Agency. Since beginning my time at FHFA in January, it has been a pleasure getting to know the very qualified staff at FHFA and working with them toward our common priorities, and I want to thank them for their service. In addition, I also want to recognize the hard work of the staff at Fannie Mae, Freddie Mac and the FHLBanks, who continue to provide important contributions to the housing finance system.

In the coming year, FHFA will continue to work to achieve the agency's statutory mandates to ensure the safe and sound operations of the regulated entities and to ensure that they provide liquidity in the national housing finance market. In addition, FHFA will continue to advance its Office of Minority and Women Inclusion responsibilities, which include furthering diversity in management, employment and business activities at FHFA, as well as at our regulated entities.

Thank you again for having me here this morning, and I look forward to answering your questions.